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April 26, 1994

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BY HAND DELIVERY

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

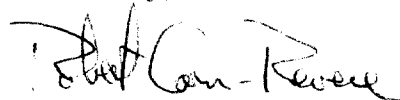
Re: Ex Parte Presentation in MM Docket 92-266

Dear Mr. Caton:

This is to notify you that Anthony S. Harrington and Robert Corn-Revere, representing Ovation: The Fine Arts Channel, attended meetings on April 21 with Commissioner James H. Quello and Legal Advisor Maureen O'Connell and with FCC Chief of Staff Blair Levin. The discussions focused on possible clarifications and/or modifications of the Commission's rate regulations as they relate to cable television programming services. The subject areas discussed are summarized in the attached memorandum.

Two copies of this letter have been submitted to the Office of the Secretary, pursuant to Section 1.1206 of the Commission's rules.

Sincerely,



Robert Corn-Revere

Enclosure(s)

cc: Commissioner James H. Quello
Blair Levin

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OVATION, INC.

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY
April 21, 1994

FCC Cable Television Rate Regulations
Incentives for New Programming and Channel Expansion

Overview

According to press accounts, approximately 70 new programming channels are scheduled to launch during the coming year. However, the latest round of cable rate reductions threaten to stunt the growth of new services. Many cable operators have put expansion plans on hold, and growth that occurs may be limited to established services with name brands (e.g., ESPN 2). See generally McAvoy, *Deciphering the FCC's New Cable Rules*, BROADCASTING & CABLE, April 11, 1994 at 50, 51. Even well-established programmers with proven track records are finding it difficult to find available channels on cable systems. See, e.g., Kolbert, *A Turner Channel Seeks Carriers*, NEW YORK TIMES, April 11, 1994 at D5.

Some impediments exist because of the way the substantive and procedural rules interact, while others stem from the substance of the rules themselves. Whatever the cause, the burden of uncertainty falls most heavily on new, innovative and independent programming services. The FCC has expressed a willingness to promote new services and channel expansion. However, its rules will have the opposite effect in the absence of quick remedial action.

- By overemphasizing the need to reduce rates, the Commission's rules run counter to the majority of the principal goals established by Congress, most of which relate to programming. As set out in Section 1(b) of the 1992 Cable Act, "[i]t is the policy of the Congress in this Act to --
 - (1) promote the availability to the public of a diversity of views and information through cable television and other video distribution media;
 - (2) rely on the marketplace, to the maximum extent feasible, to achieve that availability;
 - (3) ensure that cable operators continue to expand, where economically justified, their capacity and the programs offered over their cable systems;

- (4) where cable systems are not subject to effective competition, ensure that consumer interests are protected in the receipt of cable service; and
 - (5) ensure that cable television operators do not have undue market power vis-a-vis video programmers and consumers."
- Complex new regulations actually create substantial disincentives so that few, if any, independent new networks can be successfully launched, despite the wide-spread favorable reception otherwise received by Ovation.
 - Regulations disfavor programming diversity and development and channel expansion and enhance monopoly advantages. In particular, rules favor existing networks by entrenching existing channel or tier positions.
 - Initial steps to create incentives appear to have been negated by extent of focus on blocking any potential for abuse by operators.
 - Quick action, through interpretation and expedited reconsideration, is necessary or funding and distribution opportunities for new networks will be lost.

Problem: The 7.5% markup for the addition of new channels will not provide a sufficient incentive to add new channels and will entrench existing programming services.

- Because the mark-up is calculated as a percentage of programming costs, operators have a clear incentive to add the highest-priced channels in order to maximize profits. Therefore, the 7.5% mark-up tends to discriminate against new higher-risk, low-cost channels, resulting in higher consumer costs and less program innovation.
- If the channel is free to the operator (advertiser supported), there is no cost to be passed through. In addition, there is no mark-up ($7.5 \times 0 = 0$).
- The "pass-through/mark-up" is diminished even further by deductions for "replacement" channels. This effect is heightened by the 7.5% "mark-down" for deleted channels.

Solutions:

1. New networks should be accorded a "constructive" rate and pass-through value equal to the average price for existing networks on a tier. Such incentive pricing could be limited to nationally distributed programming to prevent evasion (e.g., "fish tank" or "fireplace" channels), and could be limited to a reasonable "incubation period" to achieve economic viability, such as two years following the launch.
2. Alternatively, operators should have the option to choose the 7.5% markup on programming costs or 25 cents, whichever is higher. This would reduce the incentive to add only the most expensive channels.
3. The 7.5% network deletion charge should be eliminated. It only exacerbates the "grandfathering" of existing networks, regardless of merit and viewer preferences.

Problem: Filing for a channel upgrade or external cost increase triggers expanded rate review and refund liability that discourages the addition of programming.

- The Cable Act holds that complaints must be filed within a "reasonable time" after a rate increase. The FCC's rules provide that complaints may be filed within 6 months after a system becomes regulated, or within 45 days after a rate increase.
- Even if a system received no complaints about its initial rates, a complaint filed pursuant to a subsequent rate increase opens the system to possible liability for its entire rate structure, not just the amount represented by the latest increase. Refund liability may extend back for a one year period.
- This heightened risk of liability acts as a disincentive to making any changes, such as adding a new programming service.

Solutions:

1. Where no complaints are received by the operator within the prescribed period, subsequent rate reviews should be limited to the amount of the increase, not the entire rate.
2. If it seems that cutting off the ability to complain about the underlying rate is unduly burdensome for subscribers, the complaint period could be expanded from 45 to 90 days. After that period, however, complaints would be limited only to the amount of the increase.
3. To the extent a complaint pertains to the entire rate structure, the burden of proof should shift to the complainant for complaints filed after the "reasonable" period established by the Commission.

Problem: Filing for a channel upgrade or external cost increase must be approved by local franchising authorities, which can delay the pass-through and eliminate the incentive to add programming.

- Regulated cable systems must get prior approval before they can adjust rates to allow for external costs. Local authorities must approve external cost increases for basic rates.
- Delays can be substantial before a rate adjustment is approved. The FCC staff has said that the same procedural limits for approving basic rates apply to external cost decisions.
- General rate proceedings to approve the initial rate can further delay external cost adjustments.
- Such delay will kill new channels.
 - Neither operators, nor programmers can afford to carry these costs in the hope of an expeditious future ruling.
 - A one-month delay in approving external costs wipes out 1/12 of a year's revenue, or 8.3%. This more than offsets the 7.5% incentive.
- Rate increases are only approved prospectively. During the time that government authorities are deciding whether or not to approve the increase, external costs are lost forever.

Solution:

1. The FCC should initiate an expedited reconsideration proceeding to address procedural questions related to external costs. Specifically, it should revise the procedure to allow external cost upgrades to become effective 30 days after notice to subscribers and the filing of the relevant form with the appropriate governmental authority. This eliminates the delay issue but still retains safeguards. Price adjustments may occur only quarterly, and the justification for any increase can be thoroughly reviewed (and appropriate refunds awarded) in the event of a complaint.

Problem: The new guidelines for the regulation of à la carte programming packages will have a discriminatory impact on the introduction of new channels.

- The à la carte package option was designed to help programmers, who believed they would not survive if operators moved them to single channel à la carte. The package option was created to allow the program services to be retained in "tiers" while subscribers received a discount from the per-channel price and gained the option to buy each channel separately.
- It is believed that the new "guidelines" will preclude almost all such à la carte packages. For example, moving a "significant" number of tier channels to an à la carte package is one factor that will deny unregulated status. There are 15 factors in all, but they tend to lead to the same conclusion.
- This emphasis will return most cable channels that were moved to à la carte packages to regulated basic and cable programming service tiers that have the highest established penetration. New and untested channels that lack "brand names" will be grouped together in new à la carte packages. Since the movement of established channels to an à la carte package is considered evidence of evasion, operators will have limited discretion to employ established services as "anchor tenants" to attract subscribers to the new à la carte packages, as was done in the past.
- As a result, this à la carte policy tends to favor existing, largely traditional channels, by guaranteeing them the greatest penetration and a competitive advantage in attracting advertisers. This also will drive up to prohibitive levels the marketing costs of new programmers, who will have a much harder time establishing a presence in the market. It will likewise become difficult or impossible to attract necessary advertiser support.
- Subjecting proposed à la carte offerings to the inconsistencies and delays of thousands of local authorities will deter operators from undertaking such offerings in any acceptable time frame.

Solutions:

1. Commission guidelines must clearly allow flexibility for the inclusion of both established and start-up programming networks in à la carte packages.
2. Introduction of national programming services requires consistent application of federal law. Consequently, the FCC should retain jurisdiction over the definition of à la carte packages and negative option billing.
3. The Commission must address this issue expeditiously in order to reduce uncertainty and support the introduction of new programming services.

Problem: Contrary to announced intentions, the new regulations will not foster investment in the deployment of new technology that will lead to the creation of an information superhighway and the creation of new jobs.

- The rules governing upgrades are not entirely clear. While "significant upgrades" are covered under a streamlined cost of service approach, "normal improvements and expansions of service" remain subject to the general rate review process. Uncertainty regarding this provision discourages investment.
- In order to increase rates, operators must demonstrate that the improvements "will benefit subscribers." It is unclear what type of demonstration is required, and the strict à la carte guidelines have made operators nervous about proceeding in the absence of certain rules.
- "Frivolous" or "inefficiently incurred" costs will be deducted from price increases, thus increasing operators' uncertainty.
- No forms are yet available for the abbreviated cost of service showing.
- The 11.25% rate of return for such improvements does not take into account the significant difference between cable television services and other utilities. The Commission should provide an added incentive for the construction of advanced, broadband systems.

Solutions:

1. The Commission must act expeditiously to address unanswered questions and to put in place a process for approving system upgrades. The Commission should heavily weigh the public interest that would be served by encouraging such upgrades in its interpretations.
2. In order to enhance the incentive to expand system capacity, the Commission should consider increasing the rate of return allowed for innovative system upgrades.